HOUSE BILL 200: Appropriations Act of 2011

2011-2012 General Assembly

Committee:	Senate Appropriations/Base Budget	**Date:**	May 23, 2011
Introduced by:	Rep. Brubaker	**Prepared by:**	Cindy Avrette Committee Counsel
Analysis of:	PCS to Fourth Edition H200-CSLExf-13		

SUMMARY:* *The Proposed Senate Committee Substitute for House Bill 200, the Current Operations and Capital Improvements Appropriations Act of 2011, contains a finance package that reduces the individual income tax rates by ¼% and allows a $50,000 tax deduction for small business income for two years, 2012 and 2013. The House budget, H200 (V4), reserved $635 million for the finance committee for the 2011-2013 biennium; this PCS uses that reserve and eliminates four tax expenditures to create the necessary availability of $671.7 million. This tax relief is in addition to the $1.3 billion in expiring tax revenue.[1]

CURRENT LAW, BILL ANALYSIS, AND EFFECTIVE DATE: Part XXXI-A of the Senate PCS for House Bill 200 does the following:

- It reduces each of the individual income tax rates ¼% for taxable years 2012 and 2013: from 6%, 7%, and 7.75% to 5.75%, 6.75% and 7.5%.
- It provides an individual income tax deduction of $50,000 for net business income the taxpayer receives during the taxable year from a small business for taxable years 2012 and 2013. A small business is defined as one whose gross receipts do not exceed $825,000.
- It eliminates the individual income tax deductions for severance wages and qualified sales of a manufactured home community and the income tax credit for oyster shell recycling, effective for taxable years beginning on or after January 1, 2011.
- It eliminates the sales tax exemption for nutritional supplements sold by a chiropractor and the sales tax holiday for certain energy star products, effective October 1, 2011.
- It simplifies the calculation of individual income tax by beginning the calculation of North Carolina taxable income with federal adjusted gross income rather than federal taxable income.

Section 31A.1: Encourage Job Growth and Long-Term Economic Prosperity by Temporarily Reducing the Income Tax Burden on Individuals and Small Businesses

North Carolina's personal income tax accounts for 52% to 55% of all General Fund revenues.[2] The non-withholding portion of this tax[3] may fluctuate as much as 35% from year to year, which has contributed to the State's volatile revenue structure. Much of this volatility has occurred since the 1990s as more and more business entities have organized as limited liability entities whose income flows through the personal income tax rather than the corporate income tax.

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[1] The 1% State sales tax rate expires July 1, 2011; the corporate and individual income surtaxes expire for taxable years beginning on or after January 1, 2011.

[2] In 1970, the PIT accounted for 32.7% of General Fund revenues.

[3] The non-withholding portion of the tax consists of business income, capital gains, rental income, interest and dividends, pension income, etc.

Section 31A.1(b) and (f) of the Senate PCS for House Bill 200 temporarily reduces each of the personal income tax rates by ¼%: from 6%, 7%, and 7.75% to 5.75%, 6.75%, and 7.5%.

North Carolina has a graduated individual income tax rate, meaning the tax rate increases as the taxpayer's North Carolina taxable income amount increases. The current tax rates are 6%, 7%, and 7.75%. The ¼% reduction in each of the tax rates is effective for the 2012 and 2013 taxable years only. The rates will return to their current level for taxable years beginning on or after January 1, 2014. This subsection also eliminates the marriage penalty[4] in the tax brackets by changing the tax brackets for single taxpayers to one-half that of a married couple filing jointly.[5]

North Carolina had two graduated individual income tax rates of 6% and 7% until 1991, when the General Assembly enacted the third bracket with a rate of 7.75%. In 2001, the General Assembly created a temporary fourth income tax bracket for incomes that exceeded $200,000 for taxpayers filing as married filing jointly; the tax rate for the fourth bracket was 8.25%. The temporary fourth bracket expired for taxable years beginning on or after January 1, 2008.[6]

The General Assembly enacted a temporary surtax on individual income tax in 2009, effective for taxable years 2009 and 2010.[7] The surtax was equal to a percentage of the tax payable by the taxpayer.[8] The percentage amount varied depending upon the taxpayer's North Carolina taxable income and the taxpayer's filing status. For married filing jointly, the surtax percentage was zero for taxable incomes up to $100,000; 2% for taxable incomes[9] over $100,000 and up to $250,000; and 3% for taxable incomes[10] over $250,000.

Section 31A.1(d) of the Senate PCS for House Bill 200 provides a personal income tax deduction for the first $50,000 of net business income a taxpayer receives during a taxable year from a small business.

A small business is a business whose cumulative gross receipts from all business activity in a taxable year does not exceed $825,000. The deduction is effective for the 2012 and 2013 taxable years only; it expires for taxable years beginning on or after January 1, 2014. This change in the law would affect at least 250,000 small businesses. Of these 250,000 small businesses, more than 50% of them are sole proprietorships. Sole proprietorships must complete a Form 1040, Schedule C. The data from Schedule C indicates that more than 75% of the sole proprietorships in North Carolina have gross receipts under $1,000,000 and more than 58% have North Carolina taxable income below $60,000.

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[4] The marriage tax penalty is the result of a tax system that recognizes that a married couple's living expenses are less than the expenses of two single people living separately, but more than the expenses of one single person. In addition, if one spouse is not employed full-time, a married couple's income would be less than that of two comparable single people who work full-time, but more than that of one single person. The tax law addresses these situations through the tax brackets, the personal exemptions, and the standard deduction. The result of these tax provisions is that a married couple with only one spouse working experiences a tax reduction when they marry, a married couple where one spouse earns substantially more than the other experiences no tax reduction or increase when they marry, and a married couple with both spouses earning roughly the same amount experience a tax increase when they marry.

[5] S.L. 2001-424 eliminated the marriage tax penalty in the North Carolina standard deduction; the provision was delayed a year in S.L. 2002-126.

[6] Under the 2001 legislation, the upper income tax bracket would have expired for taxable years beginning on or after January 1, 2004. In 2003, the General Assembly extended the 2004 sunset until 2006 and in 2005 it extended the sunset until 2007. In 2006, the General Assembly reduced the upper income tax rate from 8.25% to 8% for taxable year 2007. S.L. 2001-424, S.L. 2003-284, S.L. 2205-276, and S.L. 2006-66.

[7] S.L. 2009-451 also imposed a corporate income tax surtax of 3% for taxable years 2009 and 2010.

[8] The surtax was in addition to the individual income tax owed by the taxpayer.

[9] The effective tax rates in the respective tax brackets for taxpayers subject to the 2% surtax were 6.12%, 7.14%, and 7.91% respectively.

[10] The effective graduated tax rates for taxpayers subject to the 3% surtax were 6.18%, 7.21%, and 7.98%.

The term 'business income' would not include income that is considered passive income under the Code. Section 469 of the Code, as well as various IRC tax regulations, define passive income. Form 1040, Schedule E, requires reporting of passive and non-passive income. Form 1040, Schedule C, requires the reporting of profit and loss from sole proprietorships. Form 1040, Schedule F, requires the reporting of farm income and loss.

In 2010, the General Assembly enacted a refundable tax credit for a small business that made contributions during the taxable year to the State Unemployment Insurance Fund with respect to wages paid in this State. The credit applies only to the 2010 and 2011 taxable years. For purposes of the tax credit, a small business is defined as one whose cumulative gross receipts from business activity for the taxable year does not exceed $1,000,000.

The remainder of Section 31A.1 of the Senate PCS for House Bill 200 changes the starting point for calculating North Carolina taxable income from federal taxable income to federal adjusted gross income.

Of the 35 states that begin their calculation of state taxable income with federal law, 29 use federal adjusted gross income while only 6 use federal taxable income. Federal taxable income is income after all federally allowed deductions; it includes the deductions from gross income to determine adjusted gross income and the deductions from adjusted gross income to determine taxable income. The primary differences between federal taxable income and adjusted gross income are the personal and dependency exemptions and the subtraction of either the standard deduction amount or the itemized deductions amount.

North Carolina began using federal taxable income as the starting point for this calculation in 1989. At the time, this change significantly simplified North Carolina's individual income tax; it eliminated 30 individual income tax exclusions and reduced 47 deductions and exemptions to seven[11]. Since that time, however, the number of adjustments a taxpayer must make to federal taxable income to determine North Carolina taxable income has increased from 11 to more than 40. North Carolina's current system of additions and subtractions is confusing to taxpayers and complex to administer. For example, under current law, a taxpayer must adjust the standard deduction amount and the personal and dependency exemption amounts because North Carolina does not index those amounts like the federal law does.

This section also removes obsolete provisions and makes conforming and modernizing changes to the personal income tax statutes.

Section 31A.2: Eliminate Personal Income Tax Deductions for Severance Wages and Qualified Sales of a Manufactured Home Community and the Tax Credit for Oyster Shell Recycling

Section 31A.2 equalizes the tax treatment between severance pay and unemployment benefits. Unemployment benefits are taxable[12]; up to $35,000 of severance pay is not. This section removes the tax exemption for severance wages, effective for the 2011 taxable year. The General Assembly enacted the tax exemption for severance pay in 1996.[13] Initially the exemption applied only to severance pay a taxpayer received due to the permanent closure of a manufacturing or processing plant. In 1997,[14] the General Assembly expanded the exemption to include severance pay received from any source, public or private, and due to any involuntary termination through no fault of the employee: being fired without cause, being laid off due to a reduction in force, as well as being terminated due to a plant closure.

[11] Chapter 728 of the 1989 Session Laws.
[12] North Carolina exempted up to $2,400 of unemployment benefits from State income tax for taxable years 2009 and 2010 as part of its conformity to the Internal Revenue Code. All unemployment benefits will be taxable in 2011.
[13] Chapter 13 of the 1996 Second Extra Session.
[14] S.L. 1997-525.

According to the *Biennial Tax Expenditure Report, 2009,* the deduction resulted in a $15.5 million loss of General Fund revenues, based upon 2007 returns.

Section 31A.2 eliminates the personal income tax deduction for the taxable gain from a qualified sale of a manufactured home community four years earlier than it would otherwise expire. A 'qualified sale' is a sale of land comprising a manufactured home community that is transferred in a single purchase to a group composed of a majority of the manufactured home community leaseholders, or to a nonprofit organization representing such a group. To qualify for this deduction, the taxpayer must give notice of the sale to the North Carolina Housing Finance Agency.[15] The General Assembly enacted the deduction in 2008[16], effective for taxable years beginning on or after January 1, 2008, and expiring for taxable years beginning on or after January 1, 2015. According to the *Biennial Tax Expenditure Report, 2009,* the deduction results in a loss to the General Fund of less than $100,000.

Section 31A.2 returns the sunset date for the tax credit for oyster shell recycling to its original expiration date of January 1, 2011. Since October 1, 2009, oyster shells may not be disposed in landfills. The Division of Marine Fisheries of the Department of Environment and Natural Resources operates a voluntary oyster shell donation program. The Division of Marine Fisheries purchases oyster shells in very large quantities from shucking houses at a negotiated price per bushel.[17] In 2006, the General Assembly enacted this credit to offer an additional incentive to recycle oyster shells. [18] The credit is a nonrefundable income tax credit of one dollar for each bushel of oyster shells that a taxpayer donates to the Division of Marine Fisheries. The credit may be carried forward for five years. The taxpayer may not claim a deduction for any oyster shells for which a credit is claimed. The General Assembly extended the sunset on the tax credit for recycling oyster shells from January 1, 2011, to January 1, 2013, in 2010. This section returns the expiration date to January 1, 2011. According to the *Biennial Tax Expenditure Report, 2009,* the credit results in a loss to the General Fund of less than $100,000.

Section 31A.3: Eliminate Sales Tax Exemption for Nutritional Supplements Sold by a Chiropractor at a Chiropractic Office and the Sales Tax Holiday for Certain Energy Star Products

Section 31A.3 equalizes the sales tax treatment for nutritional supplements by repealing the State and local sales and use tax exemption for supplements sold by a chiropractic physician at a chiropractic office to a patient as part of the patient's plan of treatment. There are no laws that require any dietary supplements to be sold only by health care providers. The dispensing of dietary supplements does not require a prescription. Therefore, the purchase of nutritional supplements at any place of business, other than a chiropractic office, is subject to State and local sales tax. The exemption became effective October 1, 1997.[19] The repeal of this exemption becomes effective October 1, 2011. According to the *Biennial Tax Expenditure Report, 2009,* the exemption results in a loss to the General Fund of less than $400,000.

Section 31A.3 repeals the sales tax holiday for certain energy star products, effective October 1, 2011. During the first weekend in November,[20] the following Energy Star-rated products are exempt from State and local sales and use tax: clothes washers, freezers and refrigerators, central air conditioners and room air conditioners, air-source heat pumps and geothermal heat pumps, ceiling fans, dehumidifiers, and programmable thermostats. An Energy Star-rated product is one that meets the

[15] G.S. 42-14.3 requires an owner of a manufactured home community to notify the owners of the homes in the community of intent to convert the property to another use.
[16] Section 28.27, S.L. 2008-107.
[17] In 2006, the negotiated price was 50¢ per bushel.
[18] Section 24.18, S.L. 2006-66. Recycled oyster shells offer the following value: (1) aid in the restoration of oyster populations by their placement in sanctuaries and/or estuaries; (2) landscaping purposes; and (3) nutritional supplements.
[19] S.L. 1997-369.
[20] The holiday period begins 12:01 AM on the first Friday of November and ends 11:59 PM on the following Sunday.

energy efficient guidelines set by the United States Environmental Protection Agency (EPA) and the United States Department of Energy and is authorized to carry the Energy Star label. The General Assembly enacted the holiday in 2008[21]; according to the *Biennial Tax Expenditure Report, 2009,* the holiday results in a loss to the General Fund of $1.8 million.

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[21] Section 28.12, S.L. 2008-107.